Capital Gains, Timber Basis, Capital Accounts and Depletion

Tennessee Department of Agriculture, Division of Forestry

Timber is considered a capital asset for taxpayers who qualify as "investors" or as "in the timber business" (which can include landowners who manage timber for profit). See Forestry information sheet *"Filing Status for Timber Sales"*.

The tax rate for long-term capital gains is 5% for the 10% and 15% brackets. Above the 15% bracket the rate is 15% - still low compared to the rates for ordinary income. No self-employment tax (15.3%) is paid on capital gains.

Besides providing a lower tax rate, capital gains treatment allows you to deduct the cost basis of the timber you are acquiring. Having a basis also allows you to claim a loss if the timber is destroyed by an unusual, unexpected and sudden cause (called a *casualty loss*), including fire, theft and storm.

Your *initial cost basis* is the fair market value of the timber on the first day of the year in which it was acquired, plus acquisition costs (cruise, survey, legal fees, etc). It does not include the cost of the land. A forester can assist you in establishing a cost basis retroactively from tree growth rates and old marketing reports. You do not have to establish a basis in order to get capital gains treatment.

To calculate a timber basis, first figure what percentage of FMV was contributed by timber, and then multiply that percentage by the purchase price. For example: say you buy land with a total FMV of $150,000 including $60,000 for 340 thousand board feet of timber; you paid $170,000 total (including expenses) [Note: FMV, i.e., "appraised" value and sale price are seldom equal.]

1. $60,000/150,000 = .4; that is, the timber makes up 40% of the FMV.
2. 40% of $170,000 = $68,000 = the basis for the timber. Your depletion unit is $68,000/340,000 BF = $200 per thousand board feet.

Each year, add any new capitalized costs (the cost of constructing permanent roads, reforestation costs not amortized under the special IRS 7-year amortization option) to your timber basis. Also add items you are depreciating. Each year, as you deduct depreciated costs from your income, also deduct the same costs from your timber account. The current total of costs in your timber account is called the *adjusted basis*.

The process of deducting your basis as you sell your timber is called *depletion;* the amount you can subtract per unit harvested is your *depletion unit*.

For example, you buy 10 acres of timberland for $15,000. For simplicity let's assume that this is also its appraised fair market value (FMV). The timber was appraised at $4,000, and the volume is 20,000 board feet. Your initial cost basis is the FMV of the timber ($4,000), and the depletion unit is $4,000/20,000 = $200 per thousand board feet.

Often land sells for other than appraised fair market value. In that case you must allocate the purchase price between assets (land, timber, etc.) in proportion to the FMV of each.

When you get ready to sell timber, you can determine how much to deduct from your capital gains simply by multiplying the depletion unit times the volume sold.

For example, if you sell 5,000 board feet, and if your depletion unit is $200 per thousand board feet, you can deduct 5,000 x $200/1,000 = $1,000.

It is important that you keep your timber account and volume up to date so that you have an accurate depletion unit when you sell. A pre-sale timber cruise will provide current volumes.

Separate accounts should be set up for

- land; this includes permanent road costs
- depreciable land improvements, including temporary roads, bridges, culverts, gravel, firebreaks and fences
- classes of equipment
- reforested areas and young timber. Any undepreciated expenses in these accounts are carried over to the timber account when the accounts are combined. Sub-accounts can also be set up for different stands of timber.

Report adjustments to basis and volume, and allowable basis deducted at time of sale, on Form T Schedule F; report timber sale profit on Form T Schedule C.

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